

## Internal Revenue Service

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Person To Contact:  
, ID No.

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Refer Reply To:  
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Date: MARCH 28, 2008

In Re:

### LEGEND:

Decedent	=
Spouse	=
Family Trust	=
Date 1	=
Date 2	=
Date 3	=
Child 1	=
Child 2	=
Child 3	=
Child 4	=
State	=
State Statute 1	=
State Statute 2	=
<u>a</u>	=
<u>b</u>	=
<u>c</u>	=
<u>d</u>	=

Dear :

This is in response to your October 30, 2007 letter and other correspondence requesting a ruling regarding the income, gift, estate, and generation-skipping transfer (GST) tax consequences of the proposed division and modification of the Family Trust.

The facts submitted are as follows:

Decedent died on Date 1 in State, survived by his wife, Spouse, and four adult children, Children 1-4. Spouse and Children 1-4 are currently still alive.

Item III, Paragraph 1 of Decedent's will created a Family Trust. Children 2-4 are co-trustees of the Family Trust (Trustees). The Family Trust provides that during the life of Spouse, the Trustees may pay to her all or any portion of the net income of Family Trust at least quarter-annually. The Family Trust further provides that the Trustees may also pay for her benefit so much of the corpus of the Family Trust as the Trustees deem necessary for her health, maintenance and support taking into consideration other income and assets available to her and also taking into consideration the standard of living which she enjoyed during Decedent's lifetime. Additionally, at the end of each fiscal year during Spouse's lifetime, and subject to the discretion of the Trustees, Children 1-4 may receive a distribution of income for their reasonable support, maintenance and comfort taking into consideration their income from all sources known to the Trustees.

Item III, Paragraph 1 of Decedent's will further provides, in relevant part, that upon the death of Spouse, the Trustees shall continue the Family Trust as then constituted for the benefit of Children 1-4 as follows:

The income shall be divided equally amongst Children 1-4 and paid not less often than quarter-annually. In addition, the Trustees shall pay to Children 1-4 or for their use and benefit, so much of the principal of Family Trust as the Trustees determine to be necessary or advisable for their reasonable support, maintenance and comfort, taking into consideration their income from all sources known to the Trustees. Should any of Children 1-4 die leaving descendants, such descendants of such deceased child shall be entitled to such income.

The Family Trust shall terminate one day prior to 21 years after the death of the last survivor of Spouse and Decedent's descendants who are living at the time of Decedent's death. At termination, if the Trustees are not otherwise able to give effect to the provisions of this instrument, each remaining portion of Family Trust property shall be distributed to the beneficiaries of the then current Family Trust income in the proportions in which they are beneficiaries.

Item III, Paragraph 1(c) authorizes the Trustees to divide or distribute property at such time as distributions are to be made, wholly or partly in kind, at such valuations as the Trustees deem fair and without regard to income tax basis of the property, and to sell property without court approval. Item III, Paragraph 1(d) authorizes the Trustees to perform any and all acts in the Trustees' judgment necessary or appropriate for the proper and advantageous management, investment and distribution of the Trust property.

On Date 2, Spouse, in her capacity as executor of Decedent's estate, timely filed the Decedent's estate tax return. Family Trust was funded with \$a. After the payment of \$b for the federal estate tax and \$c for State's estate tax, \$d in assets remained in

the Family Trust. On Schedule R, Spouse allocated \$d of Decedent's GST exemption to the Family Trust.

From the date of Decedent's death until Date 3, the entire corpus of the Family Trust consisted of stock in a closely held business and all of the trust's income consisted of dividends from the stock. All of the stock held by the Family Trust has now been sold. The sale of the closely held business was not anticipated at the time of Decedent's death. Not all of the family members favored the sale of the stock. As a result, the Trustees represent that the investment goals and needs of the beneficiaries have become divergent. Continuing the Family Trust as a single trust could impair the trust administration and/or could involve lengthy and expensive litigation which would result in a wasting of trust assets.

The Trustees have determined that it is in the best interests of all beneficiaries to modify and divide the Family Trust in a qualified severance into four separate trusts, one for each of the Decedent's four children. Each of the four resulting trusts would be funded pro-rata with one-fourth of each of the assets held by the Family Trust based on the fair market value of the assets on the date of severance. Each of the four resulting trusts would have identical terms to the Family Trust, except that the current beneficiaries of each of the resulting trusts will be the particular beneficiary for whom the separate trust is established and Spouse. Following the death of Spouse or any beneficiary (whichever is later), the successor beneficiary of the resulting trusts will be determined in the same manner and with the same effect as if Family Trust had not been divided into separate trusts.

One variation from the terms of the Family Trust would be regarding the filling of a Trustee vacancy. Each of the four resulting trusts would provide that a Trustee may resign or be removed as Trustee of one trust while at the same time continuing to serve as Trustee to any of the other trusts. In appointing a successor Trustee, a court would not be required to appoint the same person or entity as a successor Trustee for each of the other trusts.

State Statute 1 authorizes trustees to "modify the administrative or dispositive terms of a trust if, because of circumstances not anticipated by the settler, modification or termination will further the purposes of the trust."

State Statute 2 authorizes a state court to "direct or permit the trustee to deviate from the terms of the trust, if owing to circumstances not known to the settler and not anticipated by him, compliance would defeat or substantially impair the accomplishment of the purposes of the trust."

You have requested the following rulings:

1. The proposed division will constitute a qualified severance as described in § 26.2642-6 of the Generation-Skipping Transfer Tax Regulations and will not affect the GST tax inclusion ratio of the Family Trust.
2. The proposed division will constitute a qualified severance as described in § 26.2642-6 and will not cause any distributions from or termination of any interest in the Family Trust or in any of the four resulting trusts to be subject to the GST tax.
3. The proposed division will not result in a taxable gift for federal gift tax purposes by any beneficiary of the Family Trust.
4. The proposed division will not cause any of the value of the Family Trust or any of the value of any of the four resulting trusts to be includible in the estate of Spouse or includible in the estate of any of Decedent's named children under §§ 2033, 2036, 2037, or 2038 of the Internal Revenue Code.
5. The proposed division will result in each of the resulting trusts being treated as a separate taxpayer under § 643(f).
6. The proposed division will not result in any amount of trust property in Family Trust or in any of the resulting trusts having been deemed to be paid, credited, or distributed to any beneficiary under § 661 or § 1.661(a)-2(f) of the Income Tax Regulations.
7. The proposed division will not result in the realization by the Family Trust or any beneficiary of any income, gain, or loss under §§ 61 or 1001.
8. The proposed division will result in the assets in each of the four resulting trusts having the same basis under § 1015 and the same holding period under § 1223 as the assets have in the Family Trust.

## LAW AND ANALYSIS

### Rulings 1 and 2

Section 2601 of the Internal Revenue Code imposes a tax on every generation, skipping transfer (GST). The term "generation skipping transfer" is defined under § 2611 as a taxable distribution, a taxable termination, or a direct skip.

Section 2642(a)(1) provides that the inclusion ratio with respect to any transferred in a generation-skipping transfer is the excess (if any) of one over the "applicable fraction" determined for the trust from which the transfer is made.

Section 2642(a)(2) provides that the applicable fraction is a fraction the

numerator of which is the amount of GST exemption allocated to the trust and the denominator of which is the value of the transferred to the trust, reduced by the sum of the federal estate tax or state death tax actually recovered from the trust attributable to such and any charitable deduction allowed under § 2055 or 2522 with respect to such.

Section 2631(a), provides that, for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption which may be allocated by such individual (or his executor) to any with respect to which such individual is the transferor. Section 2631(b) provides that any allocation under § 2631(a), once made, shall be irrevocable.

Section 2632(a) provides that any allocation by an individual of his GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2642(a)(3)(A) provides that if a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter for purposes of the GST tax.

Section 2642(a)(3)(B) provides that the term "qualified severance" means the partition of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if: (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Section 2642(a)(3)(C) provides that a severance pursuant to § 2642(a)(3) may be made at any time.

Section 26.2642-6(d) of the Generation-Skipping Transfer Tax Regulations provides, in relevant part, that a qualified severance must satisfy each of the following requirements:

- (1) The single trust is severed pursuant to the terms of the governing instrument, or pursuant to applicable local law.
- (2) The severance is effective under local law.
- (3) The date of severance is either the date selected by the trustee as of which the trust assets are to be valued in order to determine the funding of the resulting trusts, or the court-imposed date of funding in the case of an order of the local court with jurisdiction over the trust ordering the trustee to fund the resulting trusts on or as of a specific date. For a date to satisfy the definition

in the preceding sentence, however, the funding must be commenced immediately upon, and funding must occur within a reasonable time (but in no event more than 90 days) after, the selected valuation date.

- (4) The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or one hundred percent, respectively. For this purpose, the fraction or percentage may be determined by means of a formula (for example, that fraction of the trust the numerator of which is equal to the transferor's unused GST exemption, and the denominator of which is the fair market value of the original trust's assets on the date of severance). The severance of a trust based on a pecuniary amount does not satisfy this requirement. For example, the severance of a trust is not a qualified severance if the trust is divided into two trusts, with one trust to be funded with \$1,500,000 and the other trust to be funded with the balance of the original trust's assets. With respect to the particular assets to be distributed to each resulting trust, each resulting trust may be funded with the appropriate fraction or percentage (pro rata portion) of each asset held by the original trust. Alternatively, the assets may be divided among the resulting trusts on a non pro rata basis, based on the fair market value of the assets on the date of severance. However, if funded on a non pro rata basis, each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance.
- (5) The terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of the separate resulting trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are the same as the beneficiaries and their respective beneficial interests with respect to the original trust before severance. With respect to trusts from which discretionary distributions may be made to any one or more beneficiaries on a non-pro rata basis, this requirement is satisfied if—
- (i) The terms of each of the resulting trusts are the same as the terms of the original trust (even though each permissible distributee of the original trust is not a beneficiary of all of the resulting trusts);
  - (ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, on a per-capita basis. For example, in the case of the severance of a discretionary trust established for the benefit of A, B, and C and their descendants with the remainder to be divided

equally among those three families, this requirement is satisfied if the trust is divided into three separate trusts of equal value with one trust established for the benefit of A and A's descendants, one trust for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants;

(iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under section 2651 than the person or persons who held the beneficial interest in the original trust; and

(iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

- (6) In the case of a qualified severance of a trust with an inclusion ratio as defined in § 26.2642-1 of either one or zero, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

In this case, \$d of Decedent's GST exemption was allocated to the Family Trust, which had \$d in assets as of Date 1, after payment of federal and State estate taxes. Thus, Family Trust has an inclusion ratio of zero.

Furthermore, it is represented that Family Trust will be severed in accordance with applicable State law. The resulting trusts will provide for the same succession of interests and beneficiaries as are provided in Family Trust. Family Trust will be severed on a fractional basis, and each resulting trust will be funded pro-rata with one-fourth of each of the assets held by the Family Trust. The resulting trusts will be treated as separate trusts for purposes of the GST tax. Accordingly, based on the facts presented and the representations made, the proposed division will constitute a qualified severance as described in § 26.2642-6.

Furthermore, since Family Trust has an inclusion ratio of zero, each resulting trust will also have an inclusion ratio of zero in accordance with § 26.2642-6(d)(6). Accordingly, based on the facts presented and the representations made, the proposed division will not cause any distributions from or termination of any interest in the Family Trust or in any of the four resulting trusts to be subject to the GST tax.

### Ruling 3

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during the calendar year by any individual.

Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Following the division of Family Trust into the resulting trusts, each beneficiary will have the same rights to the same property as the beneficiary did prior to the division of Family Trust, and no other individual will have any additional rights with respect to the income or corpus of Family Trust. Therefore, no transfer of property will be deemed to occur as a result of the division of Family Trust into the resulting trusts. Accordingly, the proposed division will not result in a taxable gift for federal gift tax purposes by any beneficiary of the Family Trust.

#### Ruling 4

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036 provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death: (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 2037 provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, if: (1) possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent, and (2) the decedent has retained a reversionary interest in the property, and the value of such reversionary interest immediately before the death of the decedent exceeds five percent of the value of such property.

Section 2038(a)(1) provides, generally, that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what



source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In order for §§ 2036-2038 to apply, the decedent must have made a transfer of property of any interest therein (except in case of a bona fide sale for adequate and full consideration in money or money's worth) under which the decedent retained an interest in, or power over, the income or corpus of the transferred property.

In the present case, the proposed division of Family Trust, as required in the trust instrument, does not constitute a transfer within the meaning of §§ 2036-2038. The beneficiaries of the trusts will have the same interest after the division as they had prior to the division. We therefore conclude that the division will not cause any of the value of the Family Trust or any of the value of any of the four resulting trusts to be includible in the estate of Spouse or includible in the estate of any of Children 1-4 under §§ 2033, 2036, 2037, or 2038.

#### Rulings 5 and 6

Section 643(f) provides that two or more trusts shall be treated as one trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of the trusts is the avoidance of federal income tax.

Section 661(a) provides that in any taxable year a deduction is allowed in computing the taxable income of a trust (other than a trust to which subpart B applies), for the sum of (1) the amount of income for such taxable year required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year, but such deduction shall not exceed the distributable net income (DNI) of the estate or trust.

Section 1.661(a)-2(f)(1) of the Income Tax Regulations provides that gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under § 643(b) and the applicable regulations, if income is required to be distributed currently.

Section 662(a) provides that there shall be included in the gross income of a beneficiary to whom an amount specified in § 661(a) is paid, credited, or required to be distributed (by an estate or trust described in § 661), the sum of the following amounts: (1) the amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not; and (2) all other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.

Accordingly, based on the facts submitted and the representations made, we conclude as follows:

While resulting trusts have the same grantor, they will have different primary beneficiaries. Therefore, based on the facts and representations submitted, we conclude that resulting trusts will be treated as separate trusts for federal income tax purposes under § 643(f).

Additionally, because the creation of the resulting trusts is a modification of Family Trust, for Federal income tax purposes, the resulting trusts are treated as a continuation of Family Trust. Therefore, the transfer of assets from Family Trust to the resulting trusts will not be treated as a distribution or termination under § 661, and will not result in the realization by Family Trust, resulting trusts, or by any beneficiary of Family Trust or resulting trusts of any income, gain, or loss.

#### Ruling 7

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in § 1011 for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under § 1001(c), except as otherwise provided in subtitle A, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that the division of a joint tenancy in stock under a partition action provided for by state law to compel the issuance of separate stock certificates is not a sale or exchange. Likewise the conversion of a joint tenancy in stock into a tenancy in common in order to extinguish the survivorship feature is a nontaxable transaction because the right of the property owners to partition is an inherent ownership right each party possessed under applicable state law.

In Cottage Savings Ass'n v. Commissioner, 499 U.S. 554 (1991), a financial institution exchanged its interests in one group of residential mortgage loans for another lender's interest in a different group of residential mortgage loans. The two groups of mortgages were considered "substantially identical" by the agency that regulated the financial institution. The issue presented was whether a sale or exchange had taken place resulting in a realization of gain or loss under § 1001. The Supreme Court concluded that § 1.1001-1 reasonably interprets § 1001(a) and stated that an exchange of property gives rise to a realization event under § 1001(a) if the properties exchanged are "materially different." Id. at 560-61. In defining what constitutes a "material difference" for purposes of § 1001(a), the Court stated that properties are "different" in the sense that is "material" so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Id. at 565. The Court held that mortgage loans made to different obligors and secured by different homes embodied distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in the loans. Id. at 566.

In the present case, the trust beneficiaries are severing their joint interests in the Family Trust. The issue is whether the trust beneficiaries would have the same property interests and legal entitlements as a result of the proposed division. The terms and conditions of each of the four resulting trusts are substantially identical to the terms and conditions of the Family Trust. Because the property interests and legal entitlements of the beneficiaries will remain unchanged by the proposed division, the division of the Family Trust is not a sale or other disposition of property under Rev. Rul. 56-437 and does not result in a material difference in the legal entitlements enjoyed by the trust beneficiaries under Cottage Savings. Thus, the proposed division would not result in the realization of any gain or loss or other taxable event under §§ 61 or 1001 of the Code to the Family Trust or any of the current trust beneficiaries.

### Ruling 8

Section 1015(b) provides that if property is acquired by a transfer in trust (other than a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer.

Section 1.1015-2(a)(1) provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer under the law applicable to the year in which the transfer was made. If the taxpayer acquired the property by transfer in trust, this basis applies whether the property be in the hands of the trustee, or the beneficiary, and whether acquired prior to termination of the trust and distribution of the property, or thereafter.

Section 1223(2) provides that, in determining the period for which a taxpayer has held property, however acquired, there shall be included the period for which such property was held by any other person, if under chapter 1, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

Based upon the information submitted and representations made, we conclude that because § 1001 does not apply to the division of the trust assets, under § 1015, the assets in each of the four resulting trusts have the same basis under § 1015 and the same holding period under § 1223 as the assets have in the Family Trust.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

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Lorraine Gardner  
Senior Counsel, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure:

Copy of letter for section 6110 purposes